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E.O. 12958: DECL: 11/17/2015
TAGS: ECON EFIN ELAB ETRD EZ PGOV
SUBJECT: CZECH REPUBLIC'S MACROECONOMIC FAIRYTALE AND MIXED EUROZONE PROSPECTS

REF: A. PRAGUE 1325
¶B. PRAGUE 1586
¶C. 04 PRAGUE 0204

Classified By: Econ Officer Karen Reider for reasons 1.4 (B) and (D)

¶1. (U) SUMMARY: The Czech Republic is enjoying unprecedented GDP growth (5.1 percent in 2Q 2005), doubling of foreign direct investment from 2004 to 2005 (to USD 10 billion), the first trade surplus since the country's birth (USD 2 billion or 1.7 percent of GDP) and a possible budget surplus. On November 1, the Ministry of Finance raised its GDP growth forecast for 2005 from 4.0 to 4.8 percent, and growth for 2006 to 4.4 percent. However, there is general consensus that this macroeconomic fairytale will not last due to the lack of structural reforms undertaken by the GOCR to enhance the flexibility and competitiveness of the Czech economy. During introductory calls at the Czech National Bank (CNB) and with local economists, econoff heard a consensus view that entry into the euro is a political decision, and that adopting the euro without adequate structure reforms would render the Czech economy impotent to deal with the downturn of the business cycle and external shocks. Between now and the expected June 2006 elections, neither the current macroeconomic stability nor the lack of political will for reforms is likely to change. However, the Finance Ministry announced the Czech Republic intends to enter the ERM-II during the second half of 2007 with the goal of joining the eurozone in 2010. END SUMMARY

¶2. (U) Econoff met separately with Czech National Bank (CNB) Deputy Governor Ludek Niedermayer, Vice-Governor Miroslav Singer, and Chief Executive Director and Board Member Michaela Erbenova to discuss the GOCR's eurozone prospects. Econoff also met with leading economists, including Raiffeisenbank Chief Economist and former Finance Minister Dr. Pavel Mertlik, Patria Finance Chief Economist David Marek, and Charles University economics professor Ondrej Schneider.

Eurozone in 2010 or 2013?

¶3. (U) The GOCR announced 2010 as its target date for adopting the euro, the third and final stage of the European Monetary Union, which means that the Czech Republic would need to start ERM-II negotiations with the European Central Bank (ECB) in 2006, then join ERM-II in mid-2007 for two and a half years prior to joining the eurozone. While the

announcement came after the Slovak Republic's earlier-than-expected announcement to join ERM-II on November 26, both the CNB and Deputy Prime Minister for Economic Affairs Martin Jahn emphasized that countries should join the eurozone when they are ready; it is not a race, as often portrayed by the media. In fact, in late October, prior to Slovakia's decision to enter ERM-II, Finance Minister Sobotka publicly announced: (1) plans to create a task force next spring to prepare for the eurozone; (2) one of his deputy finance ministers Tomas Prouza will serve as national coordinator for the euro; (3) a detailed plan of euro adoption will be available at the end of 2006, followed by a public campaign on euro benefits; (4) all price tags and wages will be listed in both euros and Czech crowns starting July 2009.

¶4. (U) According to the November 23 joint report by the CNB, Ministry of Finance and the Ministry of Industry and Trade assessing the GOCR's readiness to adopt the euro, the Czech Republic is currently in compliance with two (price stability and durability of convergence) out of the four Maastricht criteria under the EU convergence program and one criteria (exchange rate stability) can only be proven under ERM-II. Therefore, the one area of deficiency is long-term sustainability of the government financial position due to its failure to observe budgetary discipline (sovereign debt figure is well under the 60 percent/GDP convergence criteria at 24 percent/GDP). The final recommendation of the report is that the Czech Republic should not/not attempt to enter the ERM-II during 2006, and that "any future change regarding this recommendation depends primarily on progress with the public finance reform and other reforms directed at increasing the flexibility of the Czech economy, and particularly that of the labor market."

¶5. (C) CNB's Erbenova and Singer both noted that a small open economy such as the Czech Republic naturally has much to gain by adopting the euro, but that it is hardly a reason to rush in to it. Singer explained that it is best to work out the kinks now before joining the eurozone; it would be much worse for the Czech Republic to fail to meet the convergence criteria two years after adopting the euro. Erbenova stressed the need for structural reforms before the Czech Republic adopts the euro to make the economy more flexible, especially in the labor market, and lamented that reforms are going in the opposite direction. She added that the CNB was "increasingly queasy" about adopting the euro in 2010, although the CNB has remained silent about its queasiness in recognition that the euro is a political decision. Erbenova confessed that if the ruling left-center Social Democrats (CSSD) were to win in the June 2006 elections and reform continues to be stalled, the delicate CNB-government relationship would be strained.

¶6. (U) The opposition center-right Civic Democrats (ODS) does not believe the Czech Republic should adopt the euro until 2012 - 2013. In fact, President Vaclav Klaus, one of the most vocal euro-skeptics on the continent, has gone as far as to say that the Czech Republic should wait until the inevitable crash of the euro system in 10 - 15 years (per reftel C, Klaus believes that without a unified EU fiscal policy, which is only possible under full political integration a la the EU constitution, the cost of a unified monetary policy is too high to maintain). Other ODS members, including shadow Finance Minster Vlastimil Tlusty, propose the following eurozone preparation scenario: drastic cuts in taxes, followed by drastic increase in the budget deficit, which would provide needed pressure and incentive to subsequently drastically cut expenditures. Such radical ideas make analysts understandably nervous.

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Key Vulnerabilities: Fiscal Discipline and Labor Flexibility
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¶7. (U) Economists point to indexation and mandatory spending as the two main culprits requiring reform to establish fiscal discipline. The GOCR's budget is a cyclical budget, which is

indexed to the previous year's budget instead of to the previous year's spending levels. In addition, mandatory expenditures has been increasing since 2002 elections. In 2006, 62 percent of the budget will go towards mandatory expenditures, the biggest chunk of which is welfare payments. Pensions, welfare benefits and sickness benefits will make up 40 percent of the 2006 budget, reflecting an 8 percent increase from 2005, which is about 3 percent faster than the rate of economic growth. The joint report on eurozone prospects (para 4) states that the temporary decline in the government deficit to 3 percent of GDP in 2004 cannot be regarded as sustainable, and the earliest the Czech Republic would be able to fulfill the Maastricht convergence criteria for public finance sustainability is by 2008, but only if reforms continue.

¶8. (U) Charles University economist Schneider explained that the "living minimum standard" of the Czech social welfare system guarantees a certain level of benefits (by topping off unemployment benefits or by paying the entire sum), which has both fiscal and labor flexibility implications. The GOCR spends about CZK 56 billion (USD 2.33 billion) per year on social benefits (about 3 percent of GDP). The "living minimum standard" benefits received by a family of two parents and one child is just below the net average wage of Czech workers while the benefits received by a family of two parents and two children is slightly above the net average wage. Schneider noted this reality explains why low wage workers are so difficult to hire in the Czech Republic, as frequently heard from private companies. Schneider added that because the Czech labor code provides such generous benefits for all employees, the number of union members is low in the Czech Republic. Comparing the situation to the rest of Europe, Raiffeisenbank's Dr. Mertlik said the amount of Czech social benefits is not the highest in the Europe, but the standard of qualifications and enforcement of those benefits criteria is one of the loosest in Europe. The Czech labor situation and implications of the new draft labor code is reported reftel B. CNB contacts agree the flexibility of the Czech labor market has worsened since 2003, when it issued its previous assessment of the Czech Republic's eurozone prospects.

¶9. (C) Economists also believe that the inefficiency of the Czech government is another key vulnerability for public finance. CNB's Deputy Governor Niedermayer pointed to the current fiscal position -- where the Finance Ministry seems unable to fulfill its own promised budget deficit -- as evidence. Patria Finance's Marek pointed to the lack of transparency of the Czech fiscal statistics, citing the Czech Consolidation Agency as an example of something that sometime is and sometimes is not on the books as a government liability, and privatization receipts as an example of something that sometimes is and sometimes is not on the books as a budget revenue source. Dr. Schneider, who teaches Public Finance at Charles University, pointed to the absence of required audits for government ministries as one glaring problem.

CARPE DIEM ECONOMIC POLICY

¶10. (C) At end-November, the GOCR posted a small cumulative budget surplus (CZK 200 million or USD 8.3 million), after a 3.4 percent of GDP deficit (CZK 93.7 billion or USD 4 billion) in 2004. In October, the cumulative budget surplus was CZK 15.2 billion or USD 633 million. Instead of saving or investing the surplus, the Ministry of Finance is trying to spend it as fast as possible, up to the 3 percent of GDP deficit ceiling approved in the 2005 budget. The CNB attributes the unexpected fiscal surplus to increased tax revenues resulting from this year's VAT harmonization with the EU and better than forecasted economic growth. Noting the GOCR would have to spend CZK 100 billion during the last quarter of 2005 to reach the deficit ceiling, Erbenova criticized the Ministry for overstating the potential for a

budget deficit and doubts the government could achieve a deficit even with significant one-off spending. Others at the CNB and most economists assume the GOCR will meet its deficit ceiling.

¶11. (U) Parliament approved the 2006 budget on December 2, and its basic parameters are: expenditures of CZK 958.8 billion, revenue of CZK 884.4 billion, resulting in a deficit of CZK 74.4 billion (3 percent of GDP). CNB Vice Governor Singer criticized the planned deficit, saying that if there was a time to lower the government deficit, it is now when the economy is at its peak. More significant than the budget, however, is a separate bill on extra-budgetary funds, which has not yet been presented to Parliament and is routinely approved separately from the regular budget. The extra-budgetary funds will likely include transportation and infrastructure projects, which in 2005 amounted to CZK 20 billion (USD 833 million). Given the current economic boom and June 2006 Parliamentary elections, analysts anticipate the extra-budgetary spending to be "expansionary" and even bigger than usual. Post will report on the budget and the extra-budgetary fund via septel.

¶12. (C) COMMENTS: It is the government's job not only to take credit and bask in the glow of rosy macroeconomic figures, but also to look ahead and take steps to minimize the effect of an inevitable cyclical downturn in the economy. It would behoove any country to undertake costly reforms during the good times when the impact of reform is felt less than during hard times. However, the Czech government, marred with political scandals that resulted in three Prime Ministers within two and a half years, is blinded by all the rosy statistics, preoccupied with upcoming elections in June 2006, and has all but neglected those duties. Instead, the GOCR continues to pin all of its future economic prosperity on FDI inflows. This kind of all-too-common shortsightedness has been criticized by the CNB and leading economists but so far has fallen on deaf ears. As the joint report on the Czech Republic's eurozone prospects states, the loss of independent monetary policy will mean that the adjustment of the economy to shocks will place higher demands on other adjustment mechanisms -- primarily the stabilization function of public finances, labor market flexibility , and the financial system to absorb shocks. The Czech are clearly failing to learn the lesson from the examples of Germany and France, where the lack of such flexibility has resulted in prolonged economic stagnation.
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